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International Finance: The Cycle of Economic Austerity

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An Intelligence Assessment

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International Finance: The Cycle of Economic Austerity

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Economic expansion in the 1970s was due, in part, to growing economic and financial links between the OECD and Third World countries.[1] LDC growth was fueled by increased exports to the industrial West while LDC demand, underwritten in part by heavy flows of financial capital from Western commercial banks, was a significant element in OECD growth. High interest rates and a sharp reduction in export earnings from sales to depressed OECD markets have put many key LDCs under severe pressure to curb imports. This, in turn, has implications for both Western recovery and the economic and financial health of other LDCs that count heavily on exports to their financially troubled neighbors.

The Current Environment

The persistent and worsening financial situation of the LDCs is closely tied to the global recession that is now well into its third year. The LDCs are faced by two distinct but related problems:

- LDC exporters have been hit by a collapse of commodity prices without any rise in OECD demand.
- High interest rates have greatly increased debt service obligations.

Export Decline. The recession-induced falloff in OECD purchases of LDC products has been a major reason for the eroding ability of the LDCs to manage their debt. LDC exports to the OECD expanded steadily in 1976-80, rising an average of $50 billion a year, but beginning in 1981 the situation changed dramatically. The OECD recession has led to a collapse of commodity prices and to a reduction in demand for LDC products. We calculate that LDC exports to the OECD have declined by an estimated $80 billion in 1981-82. OPEC bore the brunt of this two-year revenue decline—nearly $75 billion—but non-OPEC LDCs also suffered substantially (table 1). Eight of the 12 Third World countries with the most serious debt problems suffered major declines in export earnings in 1982;[2] all of the others have experienced substantial slowdowns in expansion of exports to the OECD. Chile's exports to the OECD were off by nearly $700 million in 1981, representing a 20-percent drop in earnings. Ivory Coast, Jamaica, Kenya, the Philippines, and Thailand have had their exports reduced for two or more years in a row.

Interest Rates. The continuing runup in commercial interest rates in 1980-81 has imposed a severe burden on LDC borrowers, who can no longer count on the increase of export revenues that was prevalent for most of the past decade. The interest premium for most LDC loans is linked to the London Interbank Offer Rate (LIBOR) or to the US prime rate. We estimate that the nearly 5-percentage-point rise in interest rates that took place over 1980-81 added some $10 billion to the debt service costs of the LDCs during that period. With exports stagnant or falling, the burden of interest payments rose to over a quarter of total foreign earnings for such countries as Mexico, Brazil, Chile, and Argentina:

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Interest as a Percent of Exports of Goods and Services 25X1

	1975	1979	1981
Argentina	14	12	29
Brazil	19	29	38
Chile	17	17	31
South Korea	7	7	13
Mexico	17	23	27
Peru	12	15	19
Philippines	6	11	18
Ecuador	NEGL	12	27
Nigeria	NEGL	3	4
Venezuela	1	6	11

[1] Economic data used in this paper were obtained from standard IMF, UN, OECD, and other open sources unless noted otherwise.

[2] Nigeria, Venezuela, Ivory Coast, Jamaica, Kenya, Pakistan, the Philippines, and Thailand.

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Table 1
LDC Debt Crises: Contributing Factors

Average annual change in million US $ (except where noted)

	1976-79	1980	1981	1982
LDC exports to OECD	38,530	95,330	−21,270	−59,380
OPEC	18,980	66,780	−20,340	−53,100
Nigeria	2,230	7,000	−6,540	−6,250
Venezuela	690	2,260	1,040	−2,440
Other	16,060	57,520	−14,840	−44,410
Non-OPEC	19,550	28,550	−930	−6,280
Argentina	800	−880	−130	310
Brazil	1,220	2,200	530	320
Chile	400	630	−700	390
Ivory Coast	370	−40	−490	−160
Jamaica	25	150	−45	−70
Kenya	110	35	−190	−45
Mexico	1,730	6,130	3,640	120
Pakistan	120	110	5	−45
Philippines	500	850	−75	−610
Thailand	500	590	−15	−10
Other	13,780	18,780	3,460	−6,480
LDC imports from OECD	24,500	57,120	24,110	−4,200
OPEC	7,480	22,800	16,960	7,020
Nigeria	590	5,330	1,730	−1,380
Venezuela	880	860	1,030	1,160
Other	6,010	16,610	14,200	6,800
Non-OPEC	17,020	34,320	7,150	−11,220
Argentina	870	1,990	−1,460	−2,960
Brazil	280	1,640	−1,470	−930
Chile	270	900	480	−1,290
Ivory Coast	280	190	−600	−360
Jamaica	−30	−30	230	−15
Kenya	130	460	−420	−60
Mexico	1,610	7,090	4,100	−5,130
Pakistan	270	250	−170	410
Philippines	480	530	−40	700
Thailand	560	580	190	1,160
Other	12,300	20,720	6,310	−2,750
LIBOR *(percentage points)*	1.2	2.0	2.8	−2.5
Trade weighted dollar exchange rate *(percent)*	1.7	−0.8	17.8	13.0
Actual level of new private commercial bank lending to LDCs *(yearend total)*	35,840	42,170	64,630	
OPEC	10,520	11,810	14,010	
Nigeria	930	810	3,030	
Venezuela	3,420	7,060	6,440	
Other	6,170	3,940	4,540	

Table 1 (continued)

	1976-79	1980	1981	1982
Non-OPEC	25,320	30,360	50,620	
Argentina	1,910	2,550	3,800	
Brazil	5,430	6,280	7,150	
Chile	670	1,000	2,360	
Ivory Coast	240	600	160	
Jamaica	50	0	180	
Kenya	70	10	120	
Mexico	6,760	6,080	15,180	
Pakistan	80	590	360	
Philippines	1,700	1,390	1,500	
Thailand	400	900	880	
Other	8,010	10,960	18,930	

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The recent falloff in commercial money market rates—LIBOR has dropped 6 percentage points since June 1982—will provide badly needed relief. Nonetheless, the present level of interest payments is still high in terms of the poor outlook for export earnings.

LDC Response

Foreign Borrowing. In our judgment, many LDCs initially sought to insulate their domestic economies—and otherwise delay politically sensitive economic adjustments—from the adverse trade and financial trends by borrowing heavily from commercial banks. During 1981, medium- and long-term external debt of the non-OPEC LDCs grew by $50 billion to $350 billion; 80 percent of the gain was from private sources. Many LDCs also resorted to sharp increases in short-term borrowing because of either a desire to avoid long-term borrowing at higher rates or an inability—because of declining credit standings—to obtain longer term credits. As long as banks were willing to lend, most LDCs were able to maintain domestic consumption while avoiding serious declines in their foreign exchange reserves.

This option is no longer available to the LDCs with the most serious debt problems. Although we believe new bank lending to LDCs may approach $40 billion this year, the pace fell sharply in second-half 1982. Several factors appear to be playing a role:

- The LDCs' poor economic prospects and inability to rapidly expand sales to the OECD countries constrain private demand for funds and lender confidence in the ability of LDC borrowers to raise requisite revenues. During 1976-80, for example, the rise in non-OPEC LDC international debt was almost completely offset by rising exports. During this period the LDCs' average ratio of debt service to exports remained about 15 percent; it is now on the order of 25 percent. 25X1

- The Mexican, Argentine, and Polish payments crises shocked the banking system and increased bankers' assessments that their risks were rising. Many banks are now refusing loan requests outright; those that continue to lend are demanding a substantial premium for the increased risk. The average spread for non-OPEC LDCs is up for the third straight year, and borrowers such as Argentina and Mexico were hit earlier this year with spreads of 1.5 to 2.25 percentage points above LIBOR when they could obtain loans at all. 25X1

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Table 2
Estimated Aggregate GNP Growth

Percent

	All LDCs	Non-OPEC	Nonoil	Latin	Asian	African
1974-79	5.9	5.6	5.3	5.5	5.8	4.8
1980	5.4	5.6	4.8	5.4	5.4	5.4
1981	2.3	3.0	1.6	1.4	5.9	−1.3
1982	1.1	1.1	0.8	−0.1	3.0	−2.1

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- Lenders' problems have been compounded by recession, high interest rates, and mounting domestic business failures. With perceptions of heightened risk both at home and abroad growing rapidly, bankers report they are taking steps to protect the adequacy of their capital by curtailing lending.

Increased Austerity. With the borrowing option cut sharply, we believe the LDCs have little choice but to accommodate the OECD recession and their own financial problems by curbing economic growth, in large measure by severe reductions in imports. We expect aggregate LDC output growth this year to be on the order of 1 to 1.5 percent, the lowest rate since at least 1950. The growth rate is barely a fifth of the average growth that occurred in 1974-79. African countries have been especially hard hit because of their heavy dependence on exports of primary commodities. Latin American output growth has especially suffered from declining commodity exports and austerity-imposed cutbacks in Brazil, Mexico, and Argentina.

In most cases, the downturn in growth is an inevitable result of the inability of countries to maintain sufficient exports and imports to sustain economic development. In other cases, a deliberate program of slow growth has been the price paid to qualify for IMF funding. Some 30 LDCs are operating under, or are about to begin, IMF-mandated adjustment programs that generally include devaluation, restrictive monetary and fiscal policies, and longer term measures to boost economic efficiency (table 3). We calculate that the combined GNP of these countries is on the order of $1.1 trillion, about 60 percent of total LDC output. 25X1

LDC austerity, whether imposed by external financing constraints or by IMF requirements, may bring about political instability. In our judgment, politically powerful groups are likely to react to the fall in their living standards that will occur. That risk is probably one of the key reasons many LDCs find it difficult to comply with IMF conditions and why they tend to maintain the same sort of expansionary domestic policies—such as large budget deficits and consumer subsidies—that helped create their economic problems. 25X1

Import Cutbacks. Both OPEC and non-OPEC LDCs alike are trimming their imports. The following tabulation for a sample of financially troubled LDCs is based on data from Embassy reporting and open sources for the first six months of 1982: 25X1

Country	Import Performance (*First-half 1982 compared with first-half 1981*)
Mexico	Down 27 percent
Brazil	Down 13 percent
Argentina	Down 47 percent
Chile	Down 35 percent
Philippines	Up 5 to 6 percent
Venezuela	Up 2 to 3 percent
Nigeria	Down 9 percent (c)

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Table 3
Troubled Borrowers: Austerity Adjustment

Country	GDP Growth (*percent*)				Change in Imports (*million $*)			IMF Program			Comment
	1974-79	1980	1981	1982	1980	1981	1982 [a]	1980	1981	1982	
Argentina	2.2	−1.6	−6.0	−5.0	568	−150	−4,000	No	No	Yes	Letter of intent signed; effects of program will not be felt until 1983.
Bangladesh	6.8	5.9	6.0	0.0	670	479	122	Yes	Yes	Yes	Standby canceled this summer; new agreement possible in early 1983.
Bolivia	4.4	0.8	−1.0	0.0	−149	12	−379	No	No	No	Likely to obtain an extended fund facility in early 1983.
Brazil	6.9	8.0	−2.0	0.0	5,157	−882	−2,100	No	No	Yes	Likely to obtain approval for a three-year extended fund facility
Chile	3.9	6.0	5.0	−3.0	1,603	543	−2,256	No	No	Yes	Approval from the IMF for an extended fund facility is expected soon.
Costa Rica	5.1	1.9	−3.6	−6.0	111	617	245	No	Yes	Yes	Current facility suspended; approval expected for another credit this month.
Dominican Republic	5.0	5.4	3.4	−1.0	427	28	−431	No	No	No	Has reached agreement in principle for an extended fund facility.
Ecuador	6.4	4.6	4.0	3.0	264	−3	−85	No	No	No	IMF credit likely in early 1983.
Guyana	1.5	0.0	−6.0	−10.0	78	10	−95	Yes	Yes	Yes	Unable to comply with IMF conditions.
Honduras	4.4	2.6	0.3	0.0	183	−60	−186	Yes	Yes	Yes	Unable to comply with previous programs; obtained new loan in November 1982.
India	1.9	7.5	4.6	−0.5	4,183	819	11	No	Yes	Yes	Currently under an IMF program signed in November 1981.
Ivory Coast	7.2	6.9	1.5	1.5	528	−580	166	No	Yes	Yes	Operating under an extended fund facility arrangement signed February 1981.
Jamaica	−2.6	−3.0	1.5	1.5	186	327	−139	Yes	Yes	Yes	Operating under an extended fund facility arrangement signed April 1981.
Kenya	5.0	2.0	2.0	3.5	658	14	−4	Yes	Yes	Yes	Has had some trouble meeting IMF measures.
Liberia	2.2	−1.0	2.0	1.0	27	−56	60	Yes	Yes	Yes	Relies heavily on IMF assistance; current standby expires August 1983.
Madagascar	1.9	4.2	1.0	3.0	−4	447	152	Yes	Yes	Yes	Unable to comply with previous agreements; recently obtained a new loan.

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Table 3
Troubled Borrowers: Austerity Adjustment (continued)

Country	GDP Growth (*percent*)				Change in Imports (*million $*)			IMF Program			Comment
	1974-79	1980	1981	1982	1980	1981	1982 [a]	1980	1981	1982	
Malawi	5.1	0.9	0.5	1.5	40	−39	−28	Yes	Yes	Yes	Obtained another arrangement in August 1982.
Mexico	6.1	8.3	8.1	1.0	746	6,000	−9,400	No	No	Yes	Likely to obtain approval for a three-year standby loan.
Morocco	6.3	4.3	−1.0	2.0	626	1,095	603	Yes	Yes	Yes	Two previous programs canceled; current arrangement expires in late 1983.
Nicaragua	−1.8	10.0	0.0	0.0	556	157	−30	No	No	No	Continues to oppose IMF support because of the required austerity measures.
Pakistan	4.9	6.7	5.5	6.1	1,294	89	201	Yes	Yes	Yes	Previous facility canceled; current arrangement expires in late 1983.
Panama	3.5	4.9	3.6	1.0	261	91	103	Yes	Yes	Yes	Struggling to comply with IMF constraints.
Peru	2.3	3.1	3.9	3.5	110	258	92	No	No	Yes	Recently obtained three-year facility; targets will probably not be met.
Philippines	6.5	5.4	0.0	−1.0	1,800	593	−51	No	No	Yes	Reached agreement in principle; effects of program will not be felt until 1983.
Senegal	1.9	−6.6	−5.2	9.0	11	−16	9	No	Yes	Yes	Has shown a willingness to implement steps in support of IMF programs
Sierra Leone	1.2	3.5	2.0	−4.0	108	−188	−3	No	Yes	Yes	IMF canceled facility in April 1982; negotiations are under way for a new loan.
Sudan	3.3	−0.5	0.5	1.0	622	96	−4	Yes	Yes	Yes	Unable to meet previous IMF conditions; negotiating for a new credit.
Thailand	7.4	5.8	7.0	4.9	2,077	1,286	848	No	Yes	Yes	Current standby approved in November 1982.
Togo	2.5	0.2	−5.9	4.0	29	46	79	No	Yes	Yes	Standby disbursements suspended; approval for a new loan likely in early 1983.
Uganda	−0.9	−2.0	1.0	5.0	95	102	83	No	Yes	Yes	1981 arrangement canceled; new credit obtained this summer.
Uruguay	5.7	4.7	−0.8	−3.0	2,831	17	502	Yes	Yes	Yes	Unable to comply with IMF conditions on two previous standby loans
Venezuela	5.2	−1.2	0.3	1.0	1,158	1,632	−133	No	No	No	

Table 3
Troubled Borrowers: Austerity Adjustment (continued)

Country	GDP Growth (*percent*)				Change in Imports (*million $*)			IMF Program			Comment
	1974-79	1980	1981	1982	1980	1981	1982 [a]	1980	1981	1982	
Zaire	−2.5	2.5	−2.0	0.0	456	142	−34	No	Yes	No	IMF suspended disbursements last fall due to noncompliance.
Zambia	0.0	−0.9	−1.8	−1.0	248	54	−82	No	Yes	Yes	Current program suspended; a new loan is possible in early 1983.
Zimbabwe	0.1	11.3	12.2	2.0	451	282	159	No	Yes	Yes	Seeking IMF assistance, but apprehensive over IMF conditions.

[a] Estimates.

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We believe the import falloff was even greater during the last six months—Mexico's imports for the past three months, for example, are 50 percent lower than the comparable period in 1981. For much of 1983, any gains in export earnings probably will have to be used to meet debt service obligations rather than to boost imports. Even for countries with liberal debt rescheduling arrangements or IMF loan programs, the ability to import anything beyond fuel and food will be difficult. For some key countries, we believe the size of the import austerity demanded threatens the ability of governments to manage the decline in living standards it portends. Mexico's IMF accord, for example, will allow it to avoid a second year of precipitant decline in imports in 1983; even so, we estimate that imports will be on the order of $15 billion, down from $24 billion in 1981. If Mexico cannot meet IMF conditions and support is withdrawn, we estimate that imports could drop as low as $10 billion. Brazil, for its part, has announced a projected 20-percent drop in imports next year as part of its austerity program.

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We calculate that the bulk of the LDC import cutback will fall on the industrial countries. The OECD sold more than $300 billion worth of goods to LDCs in 1981, up from only $40 billion in 1970. Country differences are substantial, with sales to LDCs providing about 40 percent of US and Japanese exports and, in the aggregate, 15 to 20 percent of exports from Western Europe (figure 1). Because LDCs have more discretion over nonfuel and nonfood imports than over fuel and foods, most adjustment probably will take place in purchases of manufactures. The 25 key financially troubled LDCs alone purchased $50-55 billion in manufactures from the OECD last year; this constituted 18 percent of the overseas market for manufactures exports from the United States, 10 percent for Japan, and 5 percent for Western Europe (figure 2). Moreover, these LDCs provided about 10 percent of the growth in manufactures exports during the past decade (figures 3, 4, 5). 25X1

Table 4
Selected Countries: Imports and Import Trends

Billion US $

	1980		1981		1982		1983 [b]	
		Percent change [a]		Percent change		Percent change		Percent change
Mexico	18.5	54	24.4	32	15.0	−39	10.0-15.0	0 to −33
Brazil	23.0	28	22.1	−4	20.0	−10	14.0-18.0	−10 to −30
Argentina	9.4	57	9.2	−2	5.0-6.0	−35 to −46	5.0-6.0	0
Eastern Europe (hard currency)	46.4	10	42.0	−9	35.0	−17	33.6	−4

[a] Percent change over previous year.
[b] Estimated.

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OECD exporters must also cope with a dropoff in sales to Eastern Europe. The United States has been affected most heavily, followed by France and the United Kingdom. East European imports from the West fell an average of 22 percent in the first six months of the year, largely because of the sharp decline in Western bank lending to East European countries. Poland and Romania slashed imports by half, while East Germany, Yugoslavia, Bulgaria, Hungary, and Czechoslovakia reduced them an average of 15 percent. For the year, hard currency imports will be off by some 17 percent and should continue to fall through 1983. Since June, Hungary has implemented import restrictions and Yugoslavia has put in place austerity measures to reduce its unaffordable trade deficit. The improvement in trade balances will probably not eliminate Western bankers' caution about lending to the East.

Intra-LDC trade also is affected by debtor austerity. We believe there is the risk especially in South America that countries such as Bolivia, Paraguay, and Uruguay may find it increasingly difficult to finance their own debt payments and import bills if their troubled neighbors reduce purchases because of their troubled neighbors reduce purchases because of their own financing constraints. These linkages are less strong for Mexico and East European debtors, but as countries scramble for funds, even small declines in exports become troublesome (tables 5 and 6). 25X1

Quantifying the Linkages

OECD Demand and LDC Growth. The financial and economic linkages between the LDCs and the major Western economies have increased markedly over the past decade. The key linkage has been in trade ties. LDC exports to the industrial countries have expanded from $40 billion in the early 1970s to over $400 billion by 1980. Most of this gain was in oil exports; nearly half of the GNP of OPEC members, for example, comes from exports to the OECD compared with about a quarter in 1970. The linkage is less substantial for other countries; only about 12 percent of the GNP of non-OPEC LDCs comes from exports to the OECD. The ratio has remained fairly stable for more than a decade. This stability probably reflects such factors as the increasing sophistication of the domestic aspects of many LDC economies and greater intra-LDC trade. 25X1

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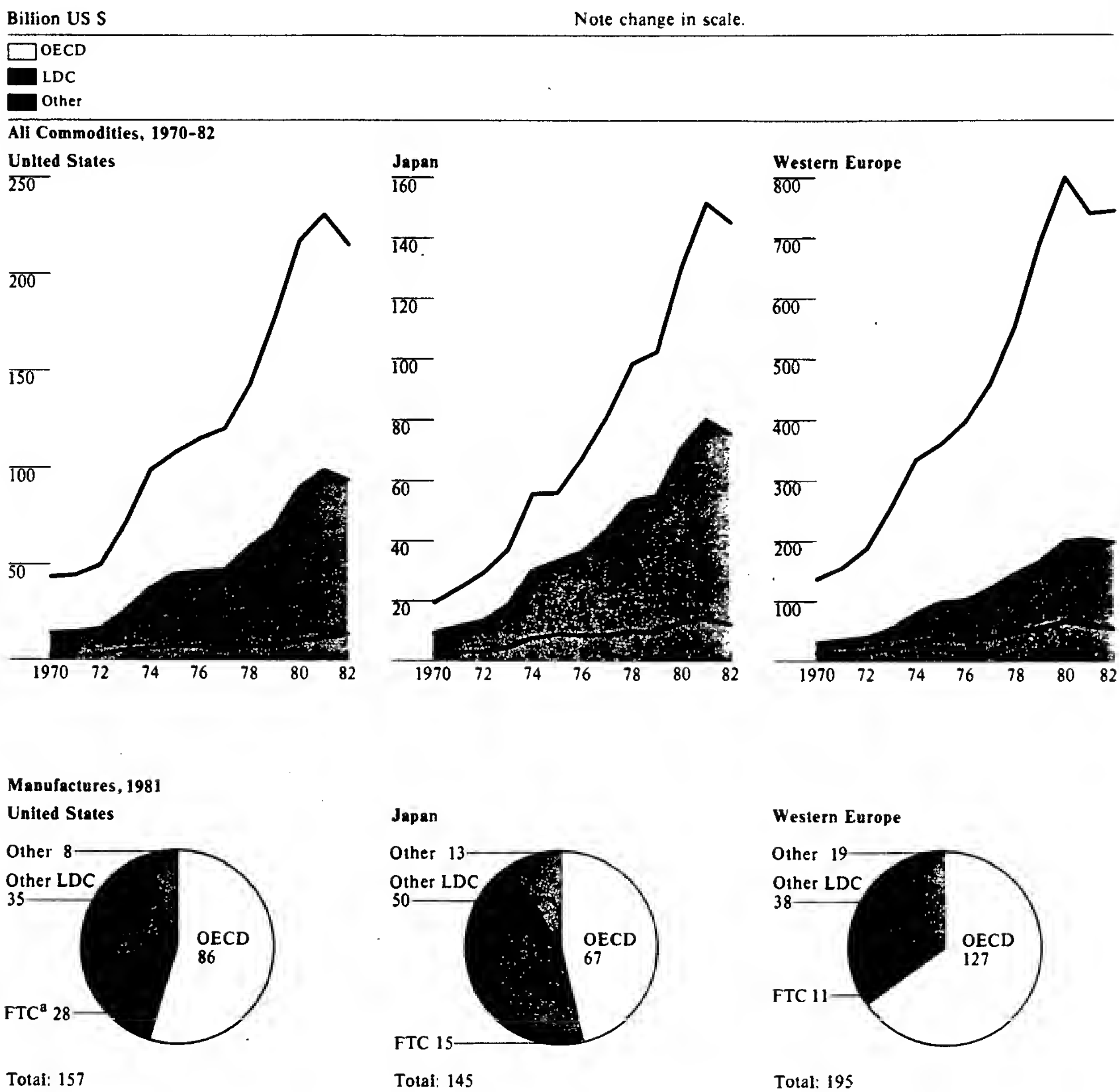
Figure 1
Industrial Countries: Direction of Exports



[a] FTC=Financially Troubled Countries; the 25 LDCs with the most severe debt repayment problems.

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Table 5
Direction of World Trade, 1980

Billion US $

Exports From/ Exports to	World	United States	Japan	Other Developed Market Economies	Africa	Latin America	Middle East	Asia	Oceania	Centrally Planned Economies
World [a]	**1,995**	240	125	980	85	130	100	150	3	230
United States	**215**		20	105	5	40	10	25	NEGL	10
Japan	**130**	30		30	5	10	15	30	NEGL	15
Other developed market economies	**920**	90	20	600	55	30	45	30	2	65
Africa	**95**	30	2	50	3	5	2	1	0	5
Latin America	**110**	40	5	30	2	25	2	1	NEGL	15
Middle East	**210**	20	40	90	4	10	10	25	NEGL	5
Asia	**140**	30	30	30	4	4	10	30	1	10
Oceania	**2**	NEGL	NEGL	NEGL	NEGL	NEGL	NEGL	NEGL	NEGL	NEGL
Centrally planned economies	**175**	2	5	50	5	5	10	10	NEGL	115

[a] Because of rounding and inconsistencies in reporting, rows and columns may not add to world total.

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Table 6
Key Debtors: Trade Linkages With Neighboring Countries

Key Debtor	Neighbor	Debtor's Share of Neighbor's Export Market (*percent*)	Major Commodities Exported to Key Debtor
Argentina	Bolivia	26	Wood, tin, gas
	Paraguay	23	Food, wood
	Chile	5	Copper, wood, pulp, plastics
	Peru	2	Manufactures
Brazil	Paraguay	18	Food, soybeans, wood
	Uruguay	11	Food, dyestuffs, rubber
	Argentina	8	Food, soybeans, leather
Mexico	Brazil	2	Machinery, transport equipment
	Chile	2	Pulp, chemicals

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Figure 2
US Trade With Latin America: Direction of Exports, 1981

Percent

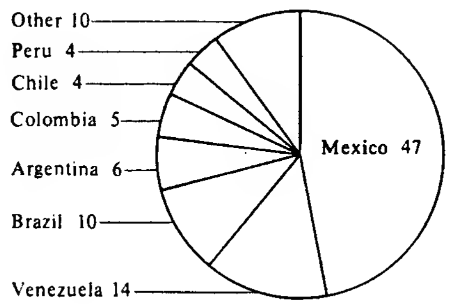

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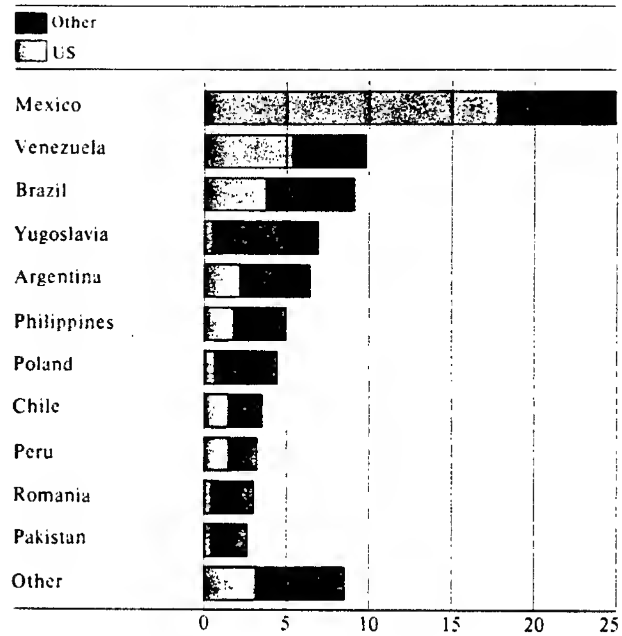
Figure 3
Financially Troubled Countries: Imports from OECD, 1981

Billion US $



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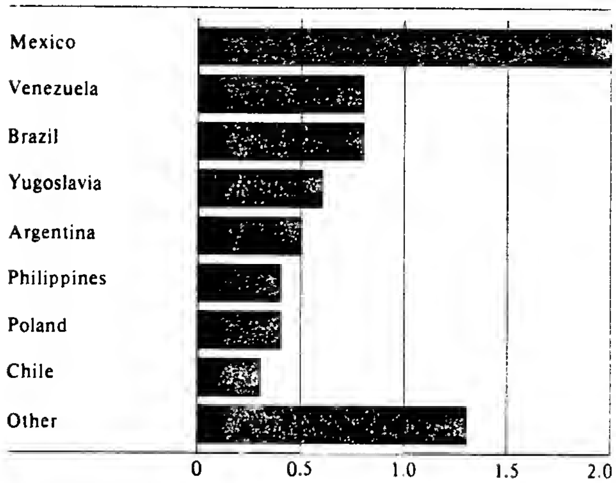
Even among non-OPEC LDCs, however, this growth link depends heavily on the relative size of their export sectors. Exports to the OECD are one-fifth of Ivory Coast's GNP but only 4 percent of Pakistan's. Among the top LDC debtors, these export-GNP shares range from 5 percent for Argentina and Brazil to 9 percent for Mexico. Although these shares are small, they are important because of the sheer size of the economies of these countries; together, they constitute 40 percent of non-OPEC LDC output. 25X1

A study prepared by the IMF in 1982 shows that slower industrial country growth rates are associated with slower LDC growth rates and vice versa. According to this study:

- A change of 1 percentage point in OECD GNP alters nonoil-LDC export volume by 2.3 percentage points. This relationship is stronger now than during the 1960s and early 1970s. The impact is especially strong on LDC exporters of manufactures—including many who are currently "troubled debtors"—and weakest for low-income exporters of primary products.
- A positive albeit weaker link exists between LDC exports and LDC economic growth. A 1-percentage point change in nonoil-LDC export volume is associated with a change in GNP growth that ranges from a 0.04 percentage point to a 0.25 percentage point, with the most plausible rate at about a 0.1 percentage point. As with the OECD growth–LDC export link, the relationship is strongest for major exporters of manufactures and weakest for low-income LDCs with exports made up largely of primary commodities. 25X1

Although this sort of relationship cannot be used for short-run projections, it does illustrate the sensitivity of LDCs to OECD growth. In its recently completed forecasting round, the OECD Secretariat projects

Figure 4
Financially Troubled Countries: Shares of Total OECD Exports, 1981



[redacted]

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Table 7
Industrial Countries:
GNP and Exports, 1981

Billion US $

	United States	Japan	Western Europe	OECD
GNP	2,940	1,130	3,020	7,520
Exports *(total)*	**235**	**150**	**740**	**1,215**
To LDCs	85	65	145	305
To OPEC LDCs	20	25	70	115
To non-OPEC LDCs	65	45	75	190
To financially troubled LDCs [a]	40	15	30	90

[a] The 25 key LDC debtors that have serious repayment problems.

[redacted] 25X1

aggregate OECD GNP growth of only 1.8 percent for 1983, the fourth consecutive year of growth under 2 percent. If, however, OECD growth were to average 4 percent, the IMF analysis suggests that an additional $15 billion could be earned by the non-OPEC LDCs to meet debt service obligations and import bills. At the same time, their own GNP would increase an additional 0.5 percentage point. [redacted]

LDC Demand and OECD Growth. Over the past decade, OECD exports to LDCs as a share of OECD countries' GNP have doubled, as shown in the following tabulation:

Percent of GNP

	Exports to LDCs		Total Exports
	1970	1981	1981
Total OECD	**2**	**4**	**16**
United States	1	3	8
Japan	3	6	13
Western Europe	2	5	24

Because most trade still takes place between industrial countries, the growth response of the OECD countries to changes in LDC growth is far less than the reverse (table 7). [redacted] 25X1

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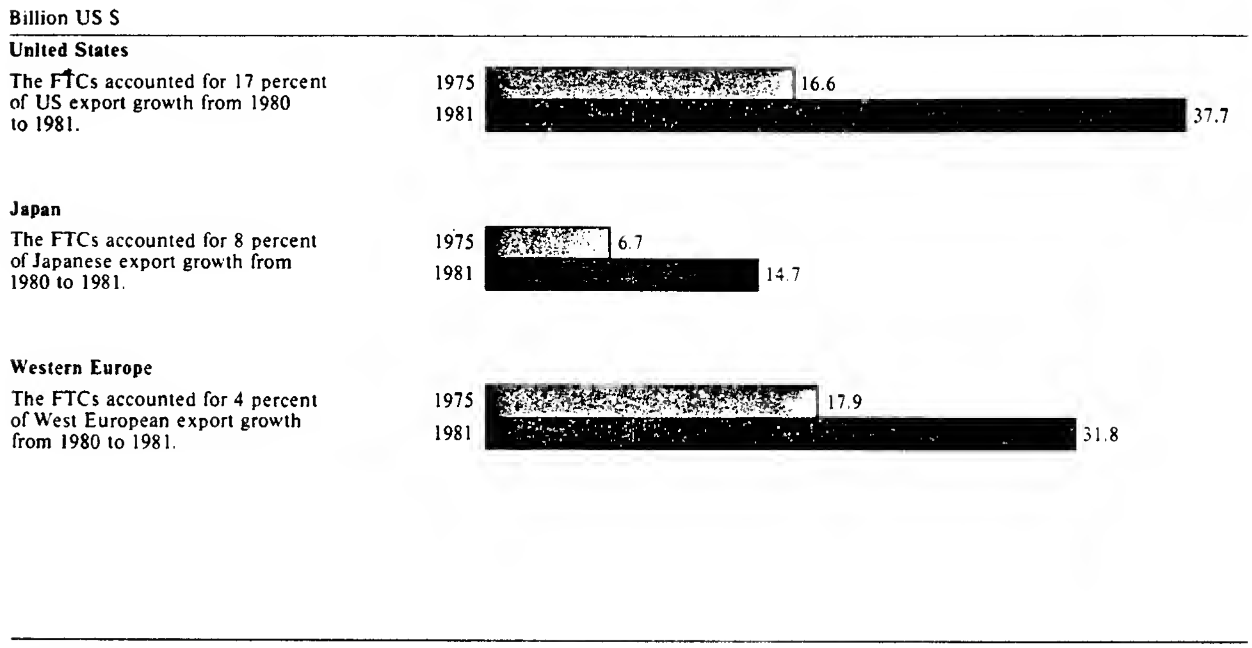
Several recent studies have tried to capture the impact on the OECD countries of a fall in LDC growth caused by a cutback in bank lending. None of these studies is directly comparable because of the differing assumptions used. They all point to similar impacts on the OECD from a decline in exports to LDCs. The actual impact on individual OECD countries from cutbacks to specific borrowers is more complex and needs to be explored further: 25X1

[redacted] 25X1

- An OECD Secretariat assessment of changes in net new bank lending to the nonoil LDCs indicates that each $10 billion drop in financial flows reduces OECD real GNP by 0.25 percentage point. Thus, if financial flows are off by $25 billion, OECD GNP growth would be down by 0.6 percentage point.

Figure 5
Exports to Financially Troubled LDC Group[a]



[a]FTC=Financially Troubled Countries; the 25 LDCs with the most severe debt repayment problems.

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- An analysis recently drafted by the Council of Economic Advisers in reference to only six "credit constrained countries"—Argentina, Brazil, Chile, Mexico, Peru, and Venezuela—assumes a $25 billion cutback in net new lending to this group. On that basis, US exports would fall by $9.2 billion directly, but the effects of linkage mean a total falloff in world trade of $59 billion and, ultimately, a $14 billion overall decline in US exports. As a result, the CEA model predicts that US GNP would fall 0.9 percentage point.

The CIA's Linked Policy Impact Model provides estimates that are roughly in line with these studies. According to this model, a $10 billion decrease in financial flows to LDCs would, if apportioned in line with usual suppliers' market shares, reduce OECD GNP by almost $20 billion, or about 0.2 percentage point. Alternatively, a $25 billion LDC import cutback as a result of an equivalent financing shortfall would result in a $49 billion fall in OECD GNP, or about 0.5 percentage point. 25X1

In practice, it may be possible for some LDCs to moderate the effect of a sharp slowing in bank financing. Imports can be reduced selectively through controls and a more realistic exchange rate policy. This kind of cutback would take exceptionally careful management—and tough political decisions—on the part of the LDCs. Most of the LDCs have been able to cut back the growth of oil imports over the last several years, and generally favorable weather has 25X1

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moderated the need for food imports. Solely on the basis of aggregate import data, however, it appears that the LDCs have squeezed a substantial amount of fat out of their import bills already and further reductions will be increasingly difficult. More research must be done on this aspect of the LDCs' adjustment process in order to gauge the full effect of financing problems on their economic development and political stability. [redacted]

The Effect of the Business Cycle

Any acceleration in the pace and timing of economic recovery in the industrial countries would provide the LDCs with needed breathing room. We believe it also would provide the banking community with a signal that LDC export prospects will improve and that LDCs are in a better position to handle their debts. The direct gains from a more rapid OECD economic expansion, however, will not occur immediately and will not be evenly distributed among the LDCs. Some will benefit sooner than others and some more than others. In our judgment, most of the initial pickup in economic activity will be concentrated in the consumer sector. Increased demand for LDC raw materials will take significantly longer to materialize in part because of the large inventory overhang for many raw materials. In the case of copper, non-Communist stocks amount to 1.2 million tons [redacted] or roughly 15 to 20 percent of annual consumption. We estimate that only a third of these stocks are under the control of raw material producers. [redacted]

Altogether, we would expect a delay in LDC export responses to stronger OECD growth of anywhere from six months to a year. For some commodities the delay will be appreciably longer. OECD demand for key LDC agricultural exports such as sugar is not sensitive to the industrial country business cycle. Beyond this, the excess capacity available for most industrial materials sold by LDCs would dampen much of the price response. Industry data show that in the case of copper the LDCs continued to expand capacity long after demand began to decline. As a result, producers are operating at only about 70 percent of capacity. A similar situation exists for many other metals and minerals. Because of these capacity overhangs, we believe competition among producers will limit the speed of any price rise. [redacted]

This is not to say that business cycle advantages to all nonoil LDCs will develop slowly. If past cycles are a guide, the LDCs that provide consumer-oriented manufactured goods will quickly capitalize on Western recovery. South Korea, Hong Kong, Taiwan, and Singapore—countries in relatively healthy financial position—would be the chief gainers. To some extent this pattern of demand will also benefit Mexico and Brazil, so long as they have access to supplier credits. 25X1

[redacted] 25X1

The Protectionist Risk

We believe growing pressures for protectionist policies in the OECD countries could derail the LDCs' response to an upturn in the business cycle. In recent months several industrial countries have been putting in place a number of policies designed to discourage imports. Although some of these barriers are aimed at aggressive industrial exporters such as Japan, they indicate a willingness to restrict imports generally:

- France now requires imported video tape recorders to clear customs at a small inland city and has instituted a stringent French language requirement for documentation on all imports. Both measures will substantially delay import processing.
- Canada is reintroducing quotas on imports of leather shoes and is attempting to use legal clauses in bilateral agreements with Hong Kong, South Korea, and Taiwan to reduce clothing imports. 25X1 25X1 25X1
- The EC is moving to restrict steel imports from LDCs in order to reduce the impact on EC steel producers of the Community's export restraint agreement with the United States. In addition, the EC is cutting textile import quotas and negotiating agreements with major textile suppliers that go beyond Multifiber Agreement limits.

We believe industrial country governments will be hard pressed to ignore pleas for relief from such industries as mining, manufacturing, and construction that have suffered disproportionately in the recession. According to the OECD Secretariat, OECD unemployment, now over 31 million, could approach 34

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million next year with rates above 10 percent. Even so, OECD manufacturers are producing far below the capacity of their factories. Even if the upturn is vigorous, we believe that industries and unions both will want to accelerate and protect their gains by reducing import competition. [redacted] 25X1

Looking Ahead

The next few months will be touch and go on the full range of issues affecting international finance, trade, and the OECD business cycle. The immediate risk is to avoid a sharp and sudden curtailment of bank lending to any particular country such as Brazil. [redacted] 25X1